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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1942.

**Nos. 11-19**

IN THE MATTER OF CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, DEBTOR.

GROUP OF INSTITUTIONAL INVESTORS AND MUTUAL SAVINGS BANK GROUP,
*Petitioners,*

*vs.*

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, ET AL.,
*Respondents.*

**No. 32**

RECONSTRUCTION FINANCE CORPORATION,
*Petitioner,*

*vs.*

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, ET AL.,
*Respondents.*

## BRIEF OF H. C. ORTON, ET AL., AS PROTECTIVE COMMITTEE FOR THE HOLDERS OF THE PREFERRED STOCK OF CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY.

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THE GUNTHORP-WARREN PRINTING COMPANY, 230 WEST JACKSON, CHICAGO

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# BRIEF OF H. C. ORTON, ET AL., AS PROTECTIVE COMMITTEE FOR THE HOLDERS OF THE PREFERRED STOCK OF CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY.

H. C. Orton, Dr. Karl A. Meyer, Rucker Penn, J. B. Johnston and D. C. Wolf, as Protective Committee for the Holders of Preferred Stock of the Chicago, Milwaukee,

St. Paul and Pacific Railroad Company, referred to hereinafter as the "Committee", herewith present their brief in which they seek to modify and alter the decision of the Circuit Court of Appeals insofar as that Court finds that the preferred stock of the Debtor is without value. The Committee has heretofore filed with this Court its petition for a writ of certiorari. The Committee's petition has neither been allowed nor denied, so that the Committee appears herein as a respondent. The interest of the preferred stockholders of the Debtor is adversely affected by the decision of the Circuit Court of Appeals, so that the Committee, even though it is a respondent, finds it necessary to attack certain portions of the Opinion. The Committee takes issue with the specification of error of the Institutional Investors in which it is asserted that the Circuit Court of Appeals erred in failing to affirm the District Court's order approving the Commission's Plan of Reorganization.

Before proceeding with its argument, the Committee finds it necessary to make a supplementary statement of facts to correct certain omissions in the Statement of Facts presented by petitioners.

## SUPPLEMENTARY STATEMENT OF FACTS.

All of the additional facts upon which reliance is placed are not set forth at this point but, on the contrary, for the sake of brevity in order that they need not be repeated, are included at that point in the argument where they are pertinent. However, the following are the vital facts upon which the Committee's claim for some treatment under the Plan of Reorganization are based:

**(a) Capital Structure:**

The capital structure of the Debtor as shown to its general balance sheet on May 31, 1935 and on December 31, 1937, is as follows (R. 2165):

| | May 31, 1935 | Dec. 31, 1937 |
|---|---|---|
| Capital stock | $224,482,604 | $224,434,854 |
| Governmental grants | 162,825 | 554,920 |
| Long-term debt | 474,076,809 | 466,497,991 |
| Total current liabilities | 23,949,957 | 57,200,062 |
| Deferred liabilities | 49,216,007 | 73,996,613 |
| Unadjusted credits | 50,101,888 | 60,237,330 |
| Corporate surplus (Def.) | 80,365,892 | 125,771,737 |
| Total liabilities | $741,624,198 | $757,140,033 |

**(b) Investment:**

**(1) Road and Equipment:**

The investment in road and equipment as of May 31, 1935 was $681,268,860; at December 31, 1937, $691,502,842. The total investment as of May 31, 1935 was $711,696,341, and as of December 31, 1937, $719,621,317. (R. 2165.)

**(2) Total Assets:**

In addition to the investment in road and equipment, there were other asset items including cash, total current

assets, deferred assets and unadjusted debits. Added to the investments in road and equipment shown immediately above, the total assets on May 31, 1935 were $741,624,198, and on December 31, 1937 were $757,140,033. (R. 2165.)

**(c) Original Cost:**

As of December 31, 1935, the original cost of the property owned by the Debtor, except land, was $694,263,606. The value of the lands and rights owned by the Debtor was $78,259,228, and the amount of working capital, $7,727,200. Therefore, the original cost of property owned, land and working capital was $780,250,034. (R. 2164.)

**(d) Cost of Reproduction:**

As of December 31, 1935, the report of the Bureau of Valuation shows the cost of reproduction of the Debtor's properties new was $818,280,465. (R. 2164.) The valuation expert of Debtor calculated this cost to be $861,677,370. (R. 1541.)

**(e) Cost of Reproduction Less Depreciation:**

The report of the Bureau of Valuation on the elements of value of the system as of December 31, 1935 shows that the cost of reproduction, less depreciation, was $546,341,054. For the Debtor, the combined cost of reproduction, less depreciation, plus the value of lands and rights, plus the working capital, as of December 31, 1935, was $632,327,582. For the Debtor and the Terre Haute, the cost of reproduction new, less depreciation, plus the value of lands and working capital, was $653,007,696 at December 31, 1935. This combined figure including the properties of the Debtor and the Terre Haute as of December 31, 1937, is $662,759,838. (R. 2164.)

The valuation expert of the Debtor testifying at the hearing before the District Court stated that the elements of value were understated by the Interstate Commerce

Commission, and that a true estimate would indicate that as of July 1, 1935, for the combined roads, the cost of reproduction new, less depreciation, plus the value of lands and rights and a stated amount of working capital, would not be less than $708,452,418. (R. 1543-4, 5.)

**(f) Rate Making Valuations:**

The final rate making value of the combined common carrier products (the Debtor and the Terre Haute) as of June 30, 1935, adjusted for depreciation, is a total of $728,446,507. The report of the Interstate Commerce Commission does not dispute the Debtor's assertion as to valuation brought down to December 31, 1937 to be $735,703,231. (R. 2164.)

**(g) Earning Record:**

**(1) Past Earnings Available for Payment of Interest:** (R. 2180)

| | As reported by the Carrier | As modified by the Committee |
|---|---|---|
| Average for ten years, 1921 to 1930 | $18,770,208 | $20,964,421 |
| Average for 18 years, 1921 to 1938, inclusive | $13,349,007 | $15,304,822 |

**(2) Current Earnings Available for Payment of Interest:**

The report of the Interstate Commerce Commission was dated February 12, 1940. The supplemental report was dated June 4, 1940. The Commission had before it the earning record for the years 1938 and 1939, although the earnings for 1939 did not appear in the record. The income available for the payment of interest for the year 1938, as reported by the carrier, was $4,962,923; as modified by the Committee, $6,023,296. (R. 2180.) The income available for interest for the year 1939 was $9,368,175. (Debtor's Ex. 3, R. 1492.)

The earning record for the full year 1940 and for a major portion of 1941, was not part of the record, but was taken into consideration in rendering its opinion:

> "This finding (that there is no value for the equity for the holders of the debtor's stock) is sharply challenged by the old stockholders who point to the present, sharp up-turn of business activities, particularly railroads, stating that the first eight months of 1941 show an increase in gross operating revenues over 1940 of 22.8%, and estimate that the income available for fixed charges for 1941 will be $31,140,682." (R. 2310.)

The Circuit Court recognizes that there was present "the question of this court's power to base its decision upon 1941 statistics which are not in the record before us." (R. 2316.)

However, since the current prosperity of the railroads of the country is a matter of which the Court must have judicial knowledge, we respectfully submit that an important fact in this case is the actual earnings during the protracted period between the close of the hearings before the Interstate Commerce Commission and the present. It is frankly admitted that some of these facts are not in the record; it is anticipated that objection will be made to their use. Yet these additional facts are of such vital importance—one of the most important of which is to indicate how very difficult it is to accurately forecast prospective earnings—that essential justice requires their consideration in this case. The income available for interest for the year 1939 was $9,368,176; for the year 1940, $14,866,992; for the year 1941, $28,939,719. Since the Circuit Court of Appeals referred to an estimated net for the year 1941, the Committee submits the final figures. The income available for interest for the first 8 months of 1942 ending August 31, 1942, was approximately $19,500,000 as against $17,991,000 for a similar period in 1941. All of this infor-

mation is on file with the Interstate Commerce Commission in accordance with the system of accounting which it has adopted.

**(3) Prospective Earnings:**

In their Plan of Reorganization for the Debtor, dated January 7, 1938, the Institutional Investors estimated that the total operating revenues for a normal year would be $126,900,000, that the net income available for interest would be $15,894,000. (Plan of Reorganization presented by Group of Institutional Investors, p. 10.) A witness for the Debtor estimated that total revenues for a normal year would be $130,000,000, the net income available for interest $20,300,000. (R. 1583.) The Interstate Commerce Commission sets up its Plan on the basis of total fixed interest charges of $4,269,654, and total interest charges of $9,489,134. (R. 2219.) Moreover, the Commission made a forecast of future earnings:—"There is no evidence whatever to indicate that a recovery of the earning power of 1928-29 is reasonably probable, and we regard it as a remote possibility only, which may not be utilized to support a finding that the debtor's stockholders have an equity." (R. 2260.)

**(h) Railway Operating Revenues:**

The railway operating revenues for the year 1939 were $106,875,380; for the year 1940, $114,373,588, for the year 1941, $139,646,122 and for the first eight months of 1942, $110,426,000 as against $88,804,000 for the same period in 1941.

**(i) Condition of the Properties:**

The Reconstruction Finance Corporation issued a report in February 1937 dealing with the Debtor. The conclusion of the report as to operating efficiency may be briefly summarized as follows (R. 1579):

a) Physical condition of track and structure has

been built up and improved in the past decade, is now adequate not only for present but also for a substantially increased traffic volume.

b) Equipment condition, both locomotive and car, is good.

c) Transportation is efficiently conducted as compared with the Northwestern Region. Excepting three iron ore carriers, the Milwaukee leads the heavy train-loading and also unit consumption of fuel, the two most important factors in achieving low ton miles.

d) The organization for and quality of management is good.

Mr. H. A. Scandrett, one of the Trustees of the Debtor, stated that, in his opinion, neither in 1935 nor as recently as September 1940, was there any deferred maintenance of consequence in the properties; that the maintenance has been adequate for the traffic handled. (R. 1504.)

Further facts as to operating efficiency as they affect earning power will be referred to in the argument.

# ARGUMENT.

## Preliminary Statement:

The Committee believes that the Interstate Commerce Commission has failed to take into consideration all of the elements necessary to determine the value of the Debtor's property; that its error has been perpetuated by the District Court, and that the Circuit Court of Appeals in agreeing with the Commission to the extent of its findings that there was no value for the preferred stock of the Debtor, has erred, and in so doing has deprived the preferred stockholders of their property in violation of the law of the land. The estimates have apparently been based upon earning power to the exclusion of *all* other elements of value. The earnings which were used as a basis for the plan were those of the depression years. The valuations ignored the fact of the improvement in the art or technique of railroading. It gave no consideration to the maintenance program which has been carried on during a greater portion of the time that the road has been under the management of the present Trustees. So far as the record shows, it gave no consideration to original cost, actual investment or cost of reproduction less depreciation. The valuation was based on an estimate of the ability of the Debtor to convert railway operating revenues into income available for fixed charges, which, even before the plan is consummated, has been proved to be alarmingly inaccurate.

Before undertaking to demonstrate the error committed by the Commission, the District Court and the Circuit Court of Appeals, we should first like to dispose of certain arguments which we believe have no bearing on the important issues in this case, but which have a tendency to distract the attention of the Court from the real issues.

**(a) The decision in this case must not be influenced by the delay and expense necessary to reach it.**

Throughout the proceeding there has been an ever present desire to hasten the conclusion of this case. The Interstate Commerce Commission was anxious to close the record in the case as promptly as possible, and when a request for an extended continuance was made in February 1938, the continuance extended only until March 22, 1938. Throughout the entire proceeding there seemed to be a general feeling that time was of the essence and that the work necessary properly to decide the case must be curtailed wherever possible to save time and reduce expense. The Preferred Stockholders Committee is as anxious as any party in this proceeding that it be consummated with as much dispatch as possible, if, in so doing, justice is not forfeited to that very speed. In fact, if the principle of law which the decision approves and which the Committee insists is incorrect (see Point III of this brief), namely, that the interest on creditors' claims may be calculated as of an arbitrary date fixed by the Plan and not as of the date of the filing of the petition,—then the Committee has a very real reason to urge haste. The Committee, therefore, has no desire either to delay these proceedings or to cause the outlay of unnecessary funds; but the Committee insists that this Court's action should not in any way be influenced by these so-called practical considerations. A difficult legal problem must be analyzed, decided and put into effect. Because the decision in this proceeding may require the outlay of substantial amounts of money in making a proper valuation and may require an additional extended period of time to consummate, is not an issue in this case. There has been an almost unbelievable delay in these proceedings. But the delay is not due so much to the contemplated action of any parties in this case as to the procedural steps which cannot be

readily expedited. And it should be noted that altho the Commission closed the record in March 1938, its report is dated February 1940 and its supplemental report June 1940!

The equity of the stockholders of this railroad was acquired at a cash outlay of $224,000,000. It is only reasonable that considerations of time and expense are incidental to the legal effect involved in the sacrifice of this tremendous equity. Those desiring consummation of a plan of reorganization must content themselves either with a substantial expenditure of time and money in the determination of the question whether the interests of the stockholders should be confiscated; or if it is desired to eliminate the expenditure of time and money, then the interests of the stockholders can not be arbitrarily disposed of, but must be recognized. This is still a Government of laws and not of men, and legal rights still exist in this country.

**(b) The existence of an internal conflict between the various groups of creditors and stockholders must not be over-emphasized.**

The Circuit Court of Appeals has indicated a feeling of impatience towards the various parties interested in this proceeding and has pointed out that each party is looking solely to his or its own interest, caring nothing as to the effect of its own selfishness on the other parties. This Court will not misjudge this internal struggle. The Circuit Court has failed to recognize that the procedure which must be followed under Section 77 requires that each interested group assert the arguments and facts which it deems necessary for its own protection. This is, after all, contested litigation, and sharp conflicts of interest necessarily result. If the proceeding were one which made it possible to work out a reorganization through negotiation, these conflicts could undoubtedly be adjusted. But since the

method is one of litigation, there is no alternative for any particular party to follow other than to assert vigorously his interest and his alone. The Preferred Stockholders Committee, therefore, in seeking to establish and preserve the rights of the stockholders most assuredly is not unaware of the rights and interests of the creditors of the Debtor. But since the Committee honestly believes that the Preferred Stockholders are entitled to recognition, it has no alternative under the circumstances except to maintain an aggressive position, argue solely and exclusively on the legal issues concerning those stockholders, and trust that this Court will know that although it admittedly has a selfish motive, it clearly recognizes that the creditors' claims are entitled to full recognition.

**(c) The "public interest" does not require the elimination of the stockholders' interest.**

Throughout the proceeding and in the arguments made in support of the Plan promulgated by the Interstate Commerce Commission, emphasis has been placed on the necessity of approving the Plan because it is in the "public interest" to do so, and the implication is clear that the "public interest" outweighs the sacrifice which the Preferred Stockholders must bear. The Committee is fully cognizant of the necessity of consummating a plan which does fully comply with the requirements of public interest. It agrees with the Commission, the District Court, and the Circuit Court of Appeals that it is necessary to reduce the capitalization and establish the fixed and contingent interest charges thereunder in a measure consistent with the protection of the public interest; with the necessity of simplifying the capital structure; that additions and betterment funds are essential and that they are in the public interest. It has no argument with any effort which seeks to provide an equitable distribution of the new securities

which results from a capital structure thus approved, thereby effecting a reorganization in the public interest. The Committee further agrees that the Debtor's capital structure is excessively complicated, and that it is probably desirable in the public interest to create a new structure with only two layers of system mortgages. But the Committee does not agree that the Plan, in order to be compatible with the public interest, must of necessity eliminate the interests of the preferred stockholders. There is nothing in Section 77 itself, or in the adjudicated cases, which holds that one is the corollary of the other. The requirement of Section 77(b) to the effect that a plan of reorganization "(4) shall provide for fixed charges * * * in such an amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; * * *" is a provision calculated to keep the interest bearing debt at such a point that there will be no danger of recurrence of bankruptcy. This is sound business judgment and therefore a sound legislation.

We submit for consideration the thoughts of the Interstate Commerce Commission on what makes up the public interest. In Finance Docket No. 10913, *Western Pacific Reorganization*, 230 I. C. C. 61, 87, the Commission said:

> "It will be observed that so far as the capitalization of a reorganized company is concerned, section 77 contains no limitations other than that the fixed charges of the company shall be adequately covered by the probable earnings available therefor, and that the plan as a whole shall be compatible with the public interest. The public interest is not defined, but it would seem obvious that to be compatible with the public interest, the plan must provide a capital structure for the reorganized company which will give it a reasonable opportunity to function efficiently and continuously as a going concern. This requires that

> the capitalization shall not exceed a conservative appraisal of the assets to be taken over by the reorganized company, and that proposed charges, whether fixed or contingent, shall be within its probable earning power."

Public interest, as therein defined, does not make it mandatory, or even necessary, to eliminate the interest of the preferred stockholders in order to consummate a plan of reorganization. The definition of public interest, as defined by this Court and as used in the Transportation Act of 1921, and referred to by the Institutional Investors in their brief, is said to have "direct relation to adequacy of transportation service to its essential conditions of economy and efficiency, and to appropriate provision and best use of transportation facilities, questions to which the Interstate Commerce Commission has constantly addressed itself in the exercise of the authority conferred." *New York Central Securities Corporation* v. *United States*, 287 U. S. 12, 25.

A sound capital structure and an efficient transportation system,—these are the elements which the public interest demands in any plan of reorganization under Section 77. A sound capitalization, one which is not over-burdened with fixed charges and maturing debts, can certainly be worked out without the necessity of depriving the stockholders of distressed railroads in this country of all of their interest. On the contrary, it can be argued with great effectiveness, that public interest requires that the rights of stockholders should not be eliminated unless no other alternative appears.

The Preferred Stockholders Committee requests careful scrutiny as to what the requirements of public interest are, because it is a phrase which can be misused and which has been misused by the Tribunals before which this case has already been tried, as an easy generality to justify an otherwise unjustifiable act.

Certainly the public interest demands the most careful scrutiny of the value of the rights of the preferred stockholders, and it cannot condone an attitude such as that expressed in the brief of the Reconstruction Finance Corporation wherein the elimination of the entire stock interest was not even important enough for passing comment—much less justification.

At this point, we think it wise to comment briefly on a somewhat related aspect of the subject. The Institutional Investors have described on page 63 of their brief, certain of the circumstances which existed at the time of the reorganization of the Debtor in 1928, and the Circuit Court of Appeals has vividly described the nature of that former Plan. (R. 2300.) The Preferred Stockholders Committee has no illusions about some of the principles and ideas which were embodied in the former Plan, and does not seek to defend it; but the Preferred Stockholders Committee insists that the matter before this Court in this proceeding is the Plan of Reorganization promulgated by the Interstate Commerce Commission in the year 1940, and any criticisms which may be directed to the former Plan—whether correct or not—are not to be tried in this case. The Court must determine whether under the facts as they exist today, there is no value to the equity of the preferred stockholders.

## I.

## Property Rights of Stockholders of a Railroad Corporation Cannot Be Destroyed When Such Action Is Predicated Upon a Valuation Based Primarily on Earnings, Since to Do So May Result in the Taking of Property in Violation of the Law of the Land.

The decision in this case, insofar as it affects the equity of the preferred stockholders, turns on the important question as to whether or not the value of railroad properties in Section 77 proceedings shall be based entirely

on their earning capacity. The crux of this case is expressed in one short paragraph of the opinion of the Circuit Court of Appeals:

> "Assuming as we must that the commercial value of Debtor's property consists in the expectation of income from it (*C. C. C. & St. Louis Ry. Co.* v. *Bacchus*, 154 U. S. 445) there is no support for a finding of value in Debtor's preferred or common stock. Debtor's property being productive, valuations based on other than earning bases may be considered only as such valuations may bear on earning capacity. *Consolidated Rock Products Co.* v. *DuBois*, *supra*. But modifying and elaborating on this rule, see 77(e), last paragraph." (R. 2311.)

The Commission's report finding that there was no equity for the holders of the preferred stock, is likewise based on the same reasoning. In a short resume, under the heading "Present Stocks", it makes disposition of the $224,000,000 worth of equity in the following abrupt language:

> "We disagree with the Debtor in its contention that the high earning power of the system only 10 years ago indicates the injustice of resolving all uncertainties for the future in such a manner as to forfeit the stock. There is no evidence whatever to indicate that a recovery of the earning power of 1928-29 is reasonably probable, and we regard it as a remote possibility only, which may not be utilized to support a finding that the Debtor's stockholders have an equity. In view of the earnings situation it would be improper to give controlling weight to the fact that the indicated reproduction-cost value of the property exceeds the amount of the debt." (Abst. 2259.)

The Preferred Stockholders Committee intends to argue that, even conceding that earnings constitute the basis for determining the value of railroad properties, the record does not justify a finding that there is no value for the equity. This point will be argued, and possibly should

be argued very logically at this point. But because the principle of law which the decision of the Circuit Court of Appeals establishes is so unsound, it is necessary to dispose of this point immediately as the most important single issue in this case. It is important because its effect upon the interest of the stockholders is not limited to the stockholders of the debtor railway, but applies equally to the stockholders of each and every other railroad company which unfortunately finds itself in need of reorganization under Section 77. It is not urged that the difficult decisions which must be made with respect to the adjustment of the position between the various creditors of the Debtor are not of the gravest importance, but the legal adjustments which must be made between the various classes of bondholders and other creditors differs in each railroad reorganization, and a decision in one case is not necessarily of any particular help in the decision in another. However, the rule of law which has been enunciated by the Circuit Court of Appeals by which the equity interests are forfeited has a far-reaching effect in all reorganizations, and we devote ourselves immediately and primarily to the task of pointing out its lack of validity.

**(a) Valuation Must Take Into Consideration Original Cost, Actual Investment and Cost of Reproduction New Less Depreciation as Well as Earning Power.**

The argument is not a difficult one. The argument requires merely a careful analysis of the duties imposed on the Commission by Section 77(e) with respect to the determination of value. The last paragraph of Section 77(e) is as follows:

> "If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the Court in its report on a plan. The value of any property used in railroad operation shall

be determined on a basis which will give due consideration to the earning power of the property past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required by the law of the land, in light of its earning power and all other relevant facts."

Of course, the Preferred stockholders committee concedes that "earning power" plays an important role in the determination of value, but surely the statute gives no instructions, and therefore no license, to ignore (1) present cost of production new and less depreciation, (2) original cost of the property, or (3) the actual investment. The statute clearly states that all three of these items must be considered in determining value "as may be required by the law of the land." These three elements must be considered in light of the earning power and all other relevant facts, but there is specific instruction that consideration be given. Failure to do so is fatal; the three Tribunals which have reviewed this matter have failed to do so.

First, with respect to the original costs of the property. The original cost of the property owned by the Debtor, including investment in road and equipment, land, and working capital, was $780,250,134 (R. 2165.) The total indebtedness of the Debtor at the time of the filing of the petition, was $508,047,413. Even including interest accrued to December 31, 1938,—the effective date of the Plan—and not authorized to be paid, the total indebtedness was $626,926,331,—more than $150,000,000 less than the original cost.

Second, the item of "the actual investment" must be examined.

The record in this case shows that the total investment as of May 31, 1935, was $711,696,341, and as of December

31, 1937, $719,621,317. (R. 2165.) This should be compared with the principal amount of the debt of $508,047,413.

Third, present cost of reproduction new and less depreciation. The Preferred Stockholders Committee submits that there is authority which requires consideration of cost of reproduction new and less depreciation in determining value. The decision in the case of *Smyth* v. *Ames*, 169 U. S. 466, 546, contains this statement:

> "We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stocks, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property."

It is true that doubt exists as to the soundness of the rule in the Smyth case (see dissenting opinion of Justice Brandeis in *Missouri ex rel. Southwestern Bell Telephone Company* v. *Public Service Commission of Missouri*, 262 U. S. 276). But Congress has specifically included cost of reproduction less depreciation as one of the factors and the Committee insists that it must be considered.

Looking to the record, we find that the Bureau of Valuation of the Interstate Commerce Commission filed a report, showing the elements of value of the system as of December 31, 1935, in which the cost of reproduction new of the property owned by the Debtor, except land, was

$818,280,465; that the cost of reproduction less depreciation was $546,341,054. Combining the cost of reproduction less depreciation with the value of the land and rights, plus working capital, we find the figure to be $632,327,582, as of December 31, 1935. For the Debtor and the Terre Haute, this combined figure is $653,007,696. (R. 2164.) The record contains other testimony on this subject. The valuation expert of the Debtor testified that, as of July 1, 1935, for the combined Milwaukee and Terre Haute, the cost of reproduction new, less depreciation, plus the value of land and rights, and a stated amount of working capital, would be not less than $708,452,418. (R. 1543.)

The Court is requested to consider what the cost of reproduction new, less depreciation, of these properties would be in October, 1942. Of course, it goes without saying that with the demands placed upon industry as a whole by the War, it would be utterly impossible to replace this railroad at any price. Its value to the Nation as a carrier is like that of every other railroad of the country,—inestimable. It is true that this condition did not exist at the time that the Interstate Commerce Commission filed its report. The increase of value was more apparent at the time of the hearing before the District Court, was very evident at the time of the hearing before the Circuit Court of Appeals, and is most pronounced at the present time. Surely if the cost of reproduction new, less depreciation, were calculated now, the figure would unquestionably be substantially greater than any figure presently in the record. This proceeding is still pending; the Circuit Court of Appeals has directed that it be returned to the Interstate Commerce Commission for further findings. If the Interstate Commerce Commission correctly performs its duties and makes investigation as it should of the various elements of value, including cost of reproduction new, less depreciation, then the Preferred Stockholders Committee confidently believes that there will be further substantia-

tion to their position that there is an equity for the preferred stockholders.

Although the statute does not include rate-making value as one of the elements which should be considered, here again there is further substantiation of the fact that an equity exists. The final rate-making value of the Debtor and the Terre Haute as of June 30, 1935, adjusted for depreciation, is a total of $728,446,507, and as of December 31, 1937, is $735,703,231. (R. 2164.) If the Commission sees fit to acknowledge this amount as the value for rate-making purposes, should it not at least explain why this value differs from valuation fixed for reorganization purposes? Either the public is being imposed upon by having to pay fares which are excessive, or the stockholders are being ousted without legal justification.

### (b) Earning Power of a Common Carrier or Public Utility Cannot Be the Primary Criterion of Value.

The decision of the Circuit Court of Appeals sanctions the action of the Commission and District Court in permitting value of the Chicago, Milwaukee, St. Paul and Pacific Railroad Company to be based on examination of earnings to the apparent exclusion of all other elements. This is a principle of law which we do not believe can be permitted to stand, since the injustices which it can produce, not only in this case but as a part of the body of the law of the country, are manifold. It is difficult to believe that under any circumstances can earnings be a sole and exclusive basis for determining value. So many elements can affect earning capacity. Earnings are subject to violent fluctuations. The difficulty of undertaking to determine prospective earnings (so clearly demonstrated in this very case) indicates, without need of further elaboration, that the earnings basis for valuation is a yardstick which must be used with extreme caution. To use it as the sole

measure of value—which for all intents and purposes is exactly what has happened in this proceeding, and when in so doing other elements of value are completely negatived, is to put into effect a principle of law which deprives citizens of their property in violation of the law of the land, for it permits the taking of property which has a value without consideration.

The Preferred Stockholders Committee is not unmindful of the decision of this Court in the case of *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510. The Committee fully recognizes that "meticulous regard for earning capacity" must be given; but the principal of the *Consolidated Rock Products Co.* case must be applied with care and discrimination. It is necessary first to distinguish carefully between the earning power of a public utility and that of an industrial corporation such as the Consolidated Rock Products Company. This brings us to a further reason why valuation based on earnings is a dangerous measurement in determining the soundness of a plan of reorganization for a public utility or a common carrier. The argument requires a two-fold development. First, that a common carrier is entitled to earn a fair return. Second, that regulated earnings can not be used as a measure of value for a common carrier.

Elaboration of both of these arguments need not be protracted. When a property is devoted to public use, it is entitled to the opportunity to earn a fair return on the investment. This is a vested right of which the owner cannot be deprived. A public body having regulatory authority has no right to confiscate property of a common carrier or public utility by reducing or adjusting the rates to such a point that a fair return cannot be obtained. The privilege or right of obtaining a fair return is a constitutional one. The protection is given not only for the purpose of protecting property rights of the individual, but also to

insure reasonably adequate service to the public. Without reasonable assurance of a fair return on the investment, it cannot be expected that any prudent investor will place his money in a public utility, and it is in the public interest to encourage the promotion and operation of necessary utilities. Two things follow from the recognition of this right (and we do not believe that anyone will deny its existence): First, that the regulatory order cannot negative this right by the elimination of part of the investment by its arbitrary pronouncement that the investment is too large and must be written off. Second, the very condition which makes necessary this arbitrary attempt at eliminating the investment is caused, at least to a large extent, by the very failure of the regulatory body to grant a fair return on the investment. It follows, therefore, that the action of the Commission itself in failing to recognize the right to a fair return on the investment is, in a large measure, responsible for the present position of the Debtor. The Commission does not admit that it is at least partially responsible for the condition in which the Debtor now finds itself. There are, of course, extenuating circumstances which made it difficult for the Commission to adjust the rates to permit a fair return in all cases; but surely it is repellant to a sense of justice that the Commission should be permitted, with the sanction of the courts, not only to fail in its duty to permit a fair return on the investment, but even to eliminate the investment itself.

The decisions of this Court clearly give weight to the arguments of the Committee, that regulated earnings are not a measure of value of a common carrier, and these decisions must be clearly borne in mind before the principles of the *Consolidated Rock Products Co.* case are held to apply. Railroad income is based upon rates which are established by the Interstate Commerce Commission. Many of the expenses of railroads are the subject matter of Government regulation. The Supreme Court recog-

nizes, therefore, that to base value on earnings of common carriers or public utilities is unsound.

Reference is first made to the case of *Simpson* v. *Shepard*, 230 U. S. 352, in which it was held that it was impossible to establish value based on earnings when the earnings themselves are subject to question. The Court stated:

> "The value of the use, as measured by return, cannot be made the criterion when the return itself is in question. If the return, as formerly allowed, be taken as the basis, then the validity of the State's reduction would have to be tested by the very rates which the State denounced as exorbitant. And, if the return as permitted under the new rates be taken, then the State's action itself reduces the amount of value upon which the fairness of the return is to be computed."

Mr. Justice Brandeis made the following statement in his dissenting opinion in *Missouri ex rel. Southwestern Bell Telephone Company* v. *Public Service Commission of Missouri*, 262 U. S. 276:

> "The rule of *Smyth* v. *Ames* sets the laborious and baffling task of finding the present value of the utility. It is impossible to find an exchange value for a utility since utilities, unlike merchandise or land, are not commonly bought and sold in the market, nor can the present value of the utility be determined by capitalizing its net earnings since the earnings are determined in large measure by the rate which the Company will be permitted to charge, and thus the vicious circle would be encountered."

The distinction between public utility property and that of ordinary commercial and industrial institutions, is made in the case of *West* v. *Chesapeake & Potomac Telephone Co.*, 295 U. S. 662, 672:

> "But it is to be remembered that such a property as that here under consideration is a great integrated aggregate of many and diverse elements; is not primarily intended for sale in the market but for devotion to the public use now and for an indefinite future;

and has, so far as its market value is concerned, no real resemblance to a bushel of wheat or a ton of iron."

The dissenting opinion of Mr. Justice Stone in the same case is as follows (p. 689):

"Such property has no market value because there is no market in which it is bought and sold. Market value would not be acceptable in any event because it would plainly be determined by estimates of future regulated earnings. Estimates of its value, including the items of 'overheads' and 'going concern value,' cannot be tested by any actual sale or by the actual present cost of constructing and assembling the property under competitive conditions."

The Committee respectfully submits that these authorities form a clear basis for the distinction between an industrial reorganization such as was consummated under Section 77B in the *Consolidated Rock Products* case, *supra*, and a utility reorganization. No public use is involved in the *Consolidated Rock Products Company* case. No question of a fair return on the investment was involved. The company's earnings were not supervised or regulated by a regulatory body. The managers and owners of a corporation having industrial property are completely free in the manner in which they operate and use their property and in the charges they make therefor. The managers and owners of a utility property, particularly a common carrier, have no such freedom. This distinction is a vital one which the Court will surely recognize. It is one which dictates that the use of the term "earning power" in Section 77, does not justify either the Commission or the Courts to place complete emphasis on the earning power as the basis for determining valuation. Other factors were specifically mentioned and must be specifically taken into consideration. Certainly there is nothing in Section 77 which requires, or even permits, that the earnings of a common carrier during

the worst years of the depression, which in turn was one of the worst depressions the country has ever experienced, should be the basis for the valuation of the property, particularly in view of the fact that other elements of value, if taken into consideration, would result in a completely different over-all valuation of the property.

**(c) Earning Power Must Be Used Cautiously as a Basis of Valuation Since It Must Include the Highly Dangerous Element of Prospective Earnings.**

Unquestionably, one of the most convincing reasons why the use of earnings is a dangerous criterion upon which to base a valuation which results in the forfeiture of property rights, is the fact that in relying on earnings, not only must past and present earnings be considered, but also prospective earnings. No better example of the difficulty, and for that matter danger, of attempting to estimate prospective earnings can be found than exists in this very case. The Institutional Investors in their Plan of Reorganization estimated that the total operating revenues of the Debtor in a normal year would be $126,900,000. They estimated that in such a year the income available for interest would be $15,894,000. In the year 1940—the very year in which the Commission filed its report—the gross revenue was only $114,375,000, yet the income available for fixed charges was $15,866,000. The level of income available for fixed charges was almost attained, although the gross revenue was $12,000,000 short of the amount which the Institutional Investors believed would be necessary to produce this income. A witness for the Debtor guessed better, but none too well. He estimated the gross in a normal year to be $130,000,000; the net $20,300,000. With all due respect, we believe that the Institutional Investors made a pleasant, but serious, mistake. In the year 1941, with the railway operating revenue of $139,646,000; the

income available for fixed charges was $28,139,000. With only $13,000,000 more gross, the net available was almost twice as great as that which the Institutional Investors estimated. Equally gratifying results are being produced in the year 1942, in spite of the substantially increased labor costs and drastically rising tax charges.

The Commission does not attempt to state in so many words its estimate of a normal year's gross and net income. Yet in fixing the fixed interest charges as $4,269,654, and the total interest charges as $9,489,134 it certainly sanctions the Institutional Investors' estimates and demonstates the Commission's failure to gauge "earning power". The Commission does indulge in a negative forecast of prospective earnings: "There is no evidence whatever to indicate that a recovery of the earning power of 1928-29 is reasonably probable, and we regard it as a remote possibility only, which may not be utilized to support a finding that the debtor's stockholders have an equity." (R. 2260.) That was not a very good guess!

These earning figures will be commented on elsewhere, but they are emphasized and stressed at this point for two reasons. Primarily, to show how very inaccurate the estimates of prospective earnings were. Second, to demonstrate the actual earning ability of the properties of the Debtor. It will be argued, and we will admit that the business which Debtor is presently handling is due in a great measure to production for National defense; that this type of business cannot be counted upon over any protracted period of time. This point, too, we will argue elsewhere; but it is necessary to stress here that the properties of the Debtor are of such size and capacity, they are in such splendid condition, and the management of the Debtor is so capable, that with the increased volume of business the Debtor is able to turn a surprisingly large portion of the gross revenue into net income available for interest. In other words, there stands a plant which in,

times of unprecedented demand is able not only to meet the demand so far as service is concerned, thereby satisfying public interest, but is also able to produce a handsome return in spite of unusually heavy labor charges and tax costs. There stands a plant which is so far superior in operating capacity that the Interstate Commerce Commission, which is the best informed body in the country with respect to railroad properties, has completely misjudged its ability to earn. The Institutional Investors and the Commission are not to be criticized for their failure to apprehend the earning capacity of this property; the Courts are not wrong in relying upon the Commission's estimate; but both the Commission and the Courts are grievously in error when they are willing to place a valuation on the properties of the Debtor based almost exclusively upon its earning capacity, particularly when such valuation is asserted for the purpose of permitting and sanctioning the elimination of the property rights of stockholders.

The Commission and the Courts have lost sight of the fact that the Debtor, through the investment of its stockholders as well as its creditors, has created a huge plant which is available at all times—as a public utility should be—to render adequate service. It is this very reserve plant, this stand-by equipment, that makes these properties so valuable. It is this value which must be recognized. A utility *must* render equally good service at all times, irrespective of the fact that sound business practice would require curtailment in service and, as a result, in expenses. It is for this reason that the equity cannot be said to be without value and must be recognized—in spite of depression earnings.

It stands to reason that in a reorganization proceeding, courts are never called upon to deal with properties having high earning power but owing few assets which have great physical value. But if such a situation could be

imagined, would the principle of law enunciated by the Circuit Court of Appeals still be valid? Would the value of those meagre assets be judged by earning capacity? Would a corporation having a sudden upsurge of business due to War contracts, for instance, or a service corporation such as an advertising agency be permitted to value its assets on earning power?

Fortunately, the error can still be corrected. This Court may still prevent the needless forfeiture of property rights. This Court can and should insist that, although earning power is an important element which must be taken into consideration, it may be so taken only when it is coordinated with the other elements of value. If such action is not taken, and if the principle of law which has been enunciated by the Circuit Court of Appeals in this case is not repudiated, then it is entirely possible that a property having an undisputed great physical value can be taken from its owners because at the moment of taking its income producing ability had been temporarily curtailed. This cannot be the law of the land. Certainly it should not be the law of the land.

## II.

### The Decision of the Circuit Court of Appeals That the Interstate Commerce Commission Must Make Further Findings of Fact Must Apply to Stockholders as Well as to Creditors.

Under the previous heading our argument was based solely on the legal ground that the method used by the Commission and adopted by the District Court and the Circuit Court of Appeals of determining value based essentially on earning power was illegal and in violation of the law of the land. We believe that the question to which we directed the Court's attention under the first Point is the fundamental and vital question involved in this case,

and for that reason it is argued first. But in addition, it is respectfully submitted that the decision of the Circuit Court of Appeals in this case contains an inconsistency which cannot be rationalized or explained. The Circuit Court of Appeals in reviewing and deciding this case, has agreed with the argument made by all parties objecting to the Plan, that it is necessary to refer the matter back to the Interstate Commerce Commission for further findings. The Circuit Court clearly recognizes that the Commission has failed to produce the necessary findings required by the *Consolidated Rock Products Company* case. The Circuit Court said:

> "There is undoubted support for the argument that the Commission inferentially made findings when it allocated the new securities to the old mortgages. But the fairness of that allocation is dependent upon the findings of fact. Without such findings we cannot intelligently approve or disapprove." (A. 2314.)

The opinion correctly takes into consideration many of the arguments which were made to that Court by the interested parties. The opinion is a clear recognition of the necessity imposed upon the Commission for making findings of fact to which it actually certifies. The Court clearly recognized that the Plan was defective, in that the Commission had not made such a finding of facts. But the Circuit Court of Appeals having perceived one of the glaring faults of the report and Plan of the Commission, has proceeded, so far as the stockholders are concerned, to fall into the very same error that the Commission has committed. The opinion of the Circuit Court, insofar as it applies to the preferred stockholders, is not consistent with the major premise upon which the reversal is based. The result is that a different standard is applied to the stockholders than to the creditors. The decision of the Court is based upon the inadequacy of the

findings of the Commission. Its opinion clearly instructs the Commission that before a plan can be certified by the District Court, it must make findings and that "the findings must be so specific that the Court may definitely see that in the new plan provisions for full compensation of cancelled old senior securities, and all prior preferred position is made. The findings must be sufficiently complete in these matters, that the Court may, from its examination, ascertain whether full compensation has been made for the entire bundle of rights which each of the creditors is called upon to surrender." (R. 2315.)

The very absence of adequate findings which the Court holds is fatal so far as the other interested parties are concerned, must also be fatal so far as the stockholders are concerned—more so, in fact, because the stockholders' rights are being eliminated. It is true that the Commission has made the unsupported statement that there is no equity for the preferred or common stockholders; but certainly this cannot be considered a finding such as contemplated by the Act, or even by the decision of the Circuit Court. It is obvious that the Court desires the Commission to make a definite allocation of value *in dollars* with respect to the various properties of the Debtor and with respect to its properties as a whole. The Committee, therefore, respectfully submits that it is inconsistent with the general principle upon which this case is decided, for the Circuit Court of Appeals to have reached the conclusion, especially upon the inadequate condition of the record, that the equity has no value. Section 77(e) provides that: "If the proceedings are referred back to the Commission, it shall proceed to a reconsideration of the proceedings under the provisions of sub-section (d) of this section." This allows introduction of new evidence, and indeed promulgation of an entirely new plan. The Court has gone out of its way, to give an expression of opinion as to what the Com-

mission should consider when the proceedings are referred back to it, and the Court has given instructions with respect to the treatment of the stockholders upon any reconsideration. Section 77 does not give the Court authority in such manner to tie the hands of the Commission. It should not and cannot circumscribe the new proceedings which the Court believes the Commission should take. It cannot hamper or unduly influence this new consideration.

Unquestionably and inevitably, any Court will draw preliminary conclusions from an examination of the record; but the Circuit Court itself has found that although the Commission's report indicates inferentially a finding of facts, that such inferences and such conclusions may not form the basis of a fair and equitable plan of reorganization. Only specific facts can be used as a criterion of fairness. The Committee respectfully submits that the Circuit Court, insofar as the decision affects the preferred stockholders, has fallen into the very error for which it reverses the decision of the District Court and the report of the Commission. The Court properly requires that the findings of the Commission be substantiated by very specific facts, yet it approves the elimination of the huge equity interest without the very findings which it believes to be so essential in the other phases of the proceeding.

The Circuit Court of Appeals for the 9th Circuit, in the Western Pacific Reorganization, has not fallen into the same error and inconsistency. *In re Western Pacific Railroad Company*, 124 F. (2d) 136. In that proceeding, the Court reversed *in its entirety* the order of the District Court approving the plan of reorganization, on the ground that the Commission's failure to comply with the statute by certifying the necessary valuation to the Court, vitiated the whole plan. The decision included not only the valuation of various portions of the property, but the valuation of the property as a whole. We quote from the decision:

"To determine the value of the above mentioned

claims, it was necessary to determine the value of (1) the debtor's entire property, (2) the property subject to the first mortgage now outstanding, (3) the $18,999,500 of refunding bonds pledged to secure the claims of A. C. James Company, Railroad Credit Corporation and Reconstruction Finance Corporation, and (4) the other collateral pledged to secure each of said claims. To determine the value of the refunding bonds, it was necessary to determine the value of (1) the property subject to the refunding mortgage only and (2) the property subject both to the refunding mortgage and to the first mortgage now outstanding. This, of course, necessitated a determination as to which of the debtor's property is, and which is not subject to each mortgage. *Consolidated Rock Products Co.* v. *DuBois*, *supra*.

* * *

"Lacking the requisite valuation data, the court was in no position to exercise the 'informed, independent judgment' which appraisal of the fairness of a plan or reorganization entails. *Consolidated Rock Products Co.* v. *DuBois*, *supra*. See, also, *National Surety Co.* v. *Coriell*, 289 U. S. 426, 436; *First National Bank* v. *Flershem*, 290 U. S. 504, 525; *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 115. Therefore, instead of approving the plan, the court should have entered an order dismissing the proceeding or, in its discretion and on motion of any party in interest, referring the proceeding back to the Commission for further action."

"The District Court's opinion states (34 F. Supp 501): 'It cannot be gainsaid that the Commission knows all about the debtor, its property, its history, financial and otherwise, its traffic and revenue, and its financial structure. No official body in the country is better qualified by reason of experience, ability and specialized knowledge than is the Commission to find the ultimate facts as to the debtor in relation to any of the matters mentioned.' The statement indicates a possible misconception."

In their brief, the Institutional Investors have set forth the opinion of the Circuit Court of Appeals entered in

denying the motion of the preferred stockholders to modify its opinion on December 4, 1941. The opinion of the Court of January 12, 1942, is quoted, but not in full. After having found that there is no need for further findings of fact with respect to the interest of the preferred stockholders in its original opinion, and after having re-asserted in the supplemental opinion of January 12, 1942 that it meant what it said in its original opinion, the Circuit Court nevertheless goes on to state as follows:

> "It follows that this branch of the case, the value of the equity of the debtor, evidenced by the common and preferred stock, is closed, and the I. C. C. need not further investigate or make further finding on this issue *unless it is convinced that the changed conditions in railroad earnings warrant it. In other words, the I. C. C. has jurisdiction of the matter and may, altho it is not required to do so, re-examine the evidence or receive additional evidence, if in its judgment, justice to the parties requires it.*" (Italics ours.)

Justice to the preferred stockholders does require a reconsideration by the Interstate Commerce Commission not only of the value of the properties securing the various mortgage debt, but also the valuation of the property as a whole. Perhaps our concern as to the inconsistency of the opinion of the Circuit Court of Appeals is unfounded. Perhaps, in spite of the strong language contained in its opinion and in a portion of its opinion of January 12, 1942, the Circuit Court does actually agree with the decision of the Circuit Court of the 9th Circuit in the Western Pacific Reorganization,—that the interest of all parties, stockholders as well as creditors, must again be reviewed by the Commission; but in order that there be no doubt, the Preferred Stockholders Committee urges that this Court modify the opinion of the Circuit Court of Appeals to the extent that the Interstate Commerce Commission will have definite instructions to undertake its new study on the value of the entire properties of the debtor and the reconsideration

of the rights and interests of the preferred stockholders as well as all other creditors. The Interstate Commerce Commission should be free from any limitations on the scope of its inquiry, and it should act upon the facts as they exist at the time of the new hearing.

## III.

### The Interstate Commerce Commission Has Failed to Make the Requisite Findings of Fact Upon Which to Predicate the Finding That There Is No Equity for the Preferred Stockholders and Has Ignored Important Facts and Circumstances Necessary for Its Decision.

The Plan is defective because there are no findings of value as required by Section 77. The Circuit Court of Appeals has found this to be true except as to the stockholders. We desire to proceed at this point to present to the Court the reasons of the Preferred Stockholders Committee for asserting that the Commission has made no finding of value respect to the interests of the preferred stockholders as well as the facts and circumstances to which no weight or importance has been given.

We have searched the report diligently and the following is the statement of the Commission on this subject:

> "There is no evidence whatever to indicate that a recovery of the earning power of 1928-29 is reasonably probable, and we regard it as a remote possibility only, which may not be utilized to support a finding that the debtor's stockholders have an equity. In view of the earnings situation it would be improper to give controlling weight to the fact that the indicated reproduction-cost value of the property exceeds the amount of debt." We find that the equity of the holders of the debtor's preferred stock and its common stock has no value and the holders of claims in classes 24 and 25, therefore, are not entitled to participate in the plan.

Counsel for the preferred stockholders' protective

committee argue that section 77 was enacted on the composition theory, that the doctrine of the Boyd case, *supra*, does not apply, and that the readjustment of debts can be arranged with retention of ownership by the stockholders. We are required under section 77(e) to make findings in connection with the question of submitting the plan to the stockholders, and in doing so we must consider the aggregate amount of claims of the bondholders and other secured creditors in the light of the earning power of the system, past, present, and prospective, and all relevant facts. Unless an equity for the stockholders is established we are unable to find justification for their participation in the plan. *Case* v. *Los Angeles Lumber Products Co.*, ____ U. S. ____ (Decided November 6, 1939). (R. 2260.)

The Preferred Stockholders Committee respectfully submits that the above quoted language does not comply with the provisions of Section 77(d), which reads:

"In such report the Commission shall state fully the reasons for its conclusions."

We do not believe that the statement quoted above is a compliance with the statute. We do not believe that the elements of value such as original cost, actual investment, cost of reproduction new, less depreciation, and rate-making value can be brushed aside without comment. The statement in the report is not a certification of facts. The Commission's statement is an argument and nothing more than that, and it cannot be used as the factual determination of lack of value of an equity of $224,000,000.

The brief of the Institutional Investors seeks to defend the Commission, arguing that the Commission has stated its findings in the same form that has been repeatedly determined by this Court to be adequate and lawful. Reference is made to the decisions in the *New England Divisions case*, 261 U. S. 184, and *Colorado* v. *United States*, 271 U. S. 153. In addition, the cases of *United*

*States* v. *Louisiana*, 290 U. S. 70, and *Florida* v. *United States*, 292 U. S. 1, are cited. The same argument and additional authorities are cited in the brief for the Reconstruction Finance Corporation. These cases cannot be relied upon to support the proposition for which they are cited. It is true that the Court in those cases dispensed with technical requirements and found that the Commission had actually obtained the information which was required to make an informed decision. In all of those cases except the *Colorado* case, questions of rates were involved; in the *Colorado* case the court had before it a matter of abandonment of railway property. But in none of those cases did the Court have before it the question of the validity of a finding upon which is based the forfeiture of property rights. This distinction must be clearly kept in mind, for surely the standards and requirements which must be applied in the determination of facts upon which the very existence of property interests turns, must not be subject to any doubt.

The opinion of this Court in *Consolidated Rock Products Co.* v. *DuBois*, *supra*, is controlling with respect to the nature of the findings which the Commission must undertake to make. This Court ruled in that case, on page 682, as follows:

> "On this record no determination of the fairness of any plan of reorganization could be made. Absent the requisite valuation data, the Court was in no position to exercise the 'informed, independent judgment' (*National Surety Co.* v. *Coriell*, 289 U. S. 426, 436, 53 S. Ct. 678, 681, 682, 77 L. Ed. 1300, 88 A. L. R. 1231) which appraisal of the fairness of a plan of reorganization entails."

We call attention to the language used by the Supreme Court in *National Surety Co.* v. *Coriell*, 289 U. S. 426, referred to in the Consolidated Rock opinion. In refusing to approve a plan of reorganization, the Supreme Court pointed out that there was no valuation of the assets by a

disinterested appraiser. This, together with other factors, made it necessary for the Supreme Court to state on page 436 as follows:

> "A trustworthy appraisal; an account showing the result of recent operations of the business; an accurate determination of the number of creditors, the amounts of their respective claims, and the extent to which collateral given or payments made to them might be deemed preferences; these were facts which might have influenced the court in deciding whether the plan should be approved or should be approved only upon a public sale. * * *
>
> Every important determination by the court in receivership proceedings calls for an informed independent judgment."

In the *Consolidated Rock* case, therefore, the Supreme Court has carried forward the principle previously enunciated in the *National Surety Company* case,—namely, the necessity of a trustworthy appraisal as the starting point for a plan of reorganization either in an equity procedure or in a bankruptcy reorganization. In the *Consolidated Rock* case the Supreme Court defines further the tools with which a fair plan of reorganization must be fashioned, and points out that there must not only be an appraisal but that there must be "*meticulous regard for earning capacity.*" The Court fully realizes the importance of determining, so far as possible, the earning capacity of the reorganized company. It realizes that such determination must of necessity be an estimate which cannot be determined with "mathematical certitude." The Court rules, however, on page 685—

> "But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earning record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance."

It is true that the *Consolidated Rock* case was one in which the court applied the principles hereinabove enunciated and found that the recognition of the stockholders was improper; but certainly the standards for measuring the fairness of a plan of reorganization must exist in each and every case, and must be applied for the purpose of determining the value of the stockholders' interest as well as for the purpose of protecting the creditors. In fact, the necessity for accurate valuation data is as great, if not greater, so far as the stockholders are concerned—as compared with the creditors—because the result of a failure to take every step to procure accurate valuation data may result, as in the *Milwaukee* case, in complete forfeiture of the interests of the stockholders. Therefore, although in a limited sense the *Consolidated Rock* case may very possibly be looked upon with satisfaction by the proponents of the plan of reorganization of the Debtor, the fact of the matter is that if contains the clearest statement which has come to our knowledge of the elements which form the underlying basis of a fair and equitable plan of reorganization.

We should like to review briefly the facts in this case in light of the requirements of the *Consolidated Rock Products* case.

**(a) The Plan of Reorganization of the Debtor is not predicated on an appraisal, much less a "trustworthy appraisal."**

The Interstate Commerce Commission and the District Court have failed to obtain the valuation data or make the appraisal necessary to justify the complete elimination of the preferred stockholders and the Interstate Commerce Commission, the District Court and the Circuit Court of Appeals have utterly ignored all elements necessary to correctly determine the earning capacity of the Debtor.

We have previously referred to the Commission's "findings."

We respectfully submit that the Commission has permitted itself to promulgate a plan in which it deliberately and intentionally ignored evidence of physical value and proceeded to eliminate the interests of the preferred stockholders in spite of the admitted existence of a physical value which would permit their participation. The District Court and Circuit Court of Appeals, in refusing to disaffirm the Commission, has sanctioned this injustice.

The report and record of the Commission may be searched from beginning to end and no statement can be found in which the Commission indicates its disagreement with or in any way disqualifies the statements with respect to physical value as reflected by original cost, actual investment, cost of reproduction new, less depreciation and rate-making value. On the contrary, the Commission does not dispute the accuracy of the findings as to the reproduction cost value or raise any issue with the figures on value. It merely states that "In view of the earnings situation it would be improper to give controlling weight to the fact that the indicated reproduction cost value of the property exceeds the amount of the debt." We have previously stated that the original cost was $780,250,134, the actual investment was $711,696,341, reproduction cost new, less depreciation for the combined roads at least $653,067,696 and possibly $708,452,418 and the rate-making value $728,446,507.

Most of the data with respect to physical values are based either in whole or in part on the Commission's own studies or on standards established by the Commission. The Commission does not state in so many words that those values are wrong or were improperly computed. It avoids comment on their accuracy by laying all the emphasis on earning capacity. This, we maintain, cannot be

permitted. Either those physical values are wrong, or they must be treated as correct and the capital structure based upon them. If they are wrong, then the Commission must admit fairly and frankly its previous errors—on the present facts which make those studies incorrect. And this can only be done by a current, up-to-date appraisal. The Preferred Stockholders Committee does not wish to insist on a useless and expensive study—or one which will delay reorganization. It wants reorganization *now*. But it does insist that the normal processes of condemnation—for that is what this is—be followed scrupulously, especially when there is a matter of $224,000,000 at stake!

It can readily be understood that if the physical values are clearly demonstrated to be less than the amount of the debt, great caution should be exercised in increasing the capitalization of a reorganized company on the basis of the estimated future earning power. But where, as in this case, there is no dispute as to the physical values as such, then certainly neither the Commission nor the Court has the power or authority to ignore those physical values when in so doing it results in the confiscation of the rights of parties interested in the property. This is particularly true when, as will be subsequently demonstrated, the estimated earning power of the Debtor is sufficiently large to justify optimism for the future. Without having before it an up-to-date "trustworthy appraisal"; without having before it "valuation data," which give different values from those based on Commission studies and for all intents and purposes admitted by the Commission, the Commission has deliberately ignored one of the most essential criteria to be used by it as the basis for a plan of reorganization.

**(b) The plan is unfair because it fails to give "meticulous regard" for earning capacity.**

Reference is again made to the language of the Supreme Court in the *Consolidated Rock Products* case:

> "But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earning record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance."

It is respectfully submitted that the Interstate Commerce Commission has not based its estimated earning capacity of the Debtor on an informed judgment.

**1. The "Nature" of the Debtor's properties.**

With respect to the nature of the properties, we wish to call to the attention of the Court, that the Milwaukee with its 11,000 miles of main-line trackage in 14 states, serves an extensive territory. "In the most populous section of the middle west its rails reach into the heart of a great farming and livestock section, pass through some of the Nation's greatest mining centers, and terminate in Seattle, in the midst of extensive industries of the Northwest. Large and important manufacturing interests are served by its lines. The Milwaukee's freight traffic is not only diversified,—it is well balanced. By this I mean that it is made up of well balanced portions of tonnage from basic sources. A railroad dependent for a large portion of its freight tonnage on a single industry, for example, may be badly crippled if the basic source of its revenue suffers business depression. Milwaukee freight revenue, on the other hand, has a definite measure of stability. In anything like normal times unfavorable business conditions in a single—or even in several—basic industries will not curtail its traffic to a point where its earning power will be perma-

nently affected. The Milwaukee is to a large degree a self-contained unit in the country's transportation system. By this I mean that it is less dependent on traffic received from other roads for the tonnage which it hauls, than the great majority of rail carriers. In 1939, for instance, the Milwaukee originated on its own lines 62% of the tonnage which it carried and terminated on its own lines over 65% of the tonnage thus originated. It is, therefore, less liable to suffer severe traffic losses through routing via other roads than its own. Of importance, too, is the fact that the Milwaukee has a longer average haul over its own tracks than does the average rail carrier." (R. 1574-5.)

No clearer, more concise statement can be made as to the nature of the Debtor's property.

**2. "Condition" of the Debtor's properties.**

Throughout the entire proceeding there has never been the slightest question but that the condition of the properties of the Debtor is excellent. The record clearly discloses that the condition of the properties of the Debtor is not only excellent, but has materially improved during the period of trusteeship.

The Reconstruction Finance Corporation report of February 1937, dealing with the Debtor, has been referred to in the statement of facts.

Detailed testimony as to the work which has been conducted during the period of receivership was given. It was established that the improvements which were made were so substantial that the maintenance costs in years to come would be materially reduced. Without going into any detail, the improvement program is briefly summarized as follows:

Replacing untreated ties with treated ties. (R. 1670-1.)

Maintenance of Way Expenses more or less non-recurrent. (R. 1672.)

Improvements in Shops and Engine Houses. (R. 1672.)

Improvements in Rolling Stock including installation of stokers in engines, installation of heating and air conditioning in passenger cars and purchase of Diesel engines. (R. 1673 and R. 1514.)

That the condition of the property of the Debtor has resulted in improved operation, was effectively brought out in the testimony of Dr. J. H. Parmelee. The witness effectively demonstrated that the Debtor had reached its highest state of efficiency during the administration of its properties by the Trustees. He based his conclusions after considering such factors as gross ton-miles per train hour, the freight efficiency factor of net ton-miles per train hour, average train load, average freight train speed, average percentage of equipment in unserviceable condition and fuel consumption. (R. 1580, 1581.) The witness stated: "The efficiency with which the Milwaukee is operating has been strikingly emphasized by the translation of a large portion of the increased operating revenues to net income, to which I shall refer in a moment." (R. 1581.)

After reviewing the improvements in previous years, the witness pointed out that the Debtor has been more and more successful in converting the increased gross revenue into net income so that in the 12 months ended August 31, 1940, out of every dollar of added revenue in that period, it cost only 25.7% per dollar to do the business and 74.3% of the dollar, or nearly three-fourths of the dollar, was translated into net income. (R. 1583.)

The record, therefore, is convincing that the condition of the properties is at a peak.

### 3. The "past earning record" of the Debtor.

The Commission itself recognizes the "high earning power" of the Debtor only 10 years ago. (R. 2258.) But even including the unprecedented decline of the depression years which left its mark on the earning record of every business as well as on the carriers, the earnings available for interest were substantial. The experience of the Debtor is similar to that of all other railroads during the depression period and it does not appear that the Debtor's record is indicative of any short-coming peculiar to the Debtor alone.

### 4. The "circumstances" which give a "reliable criterion of future performance."

Both the Commission and the District Court have made the calculations of future earnings based on the record during the most unfavorable period of the Debtor's history,—for that matter, during one of the greatest depressions in the history of the country. It requires no statement to support the fact that the period from 1931 through 1938 witnessed a financial catastrophe which has scarcely ever been equaled. One of the industries most seriously affected by this catastrophe is the railroads, as is evidenced by the great number of railroads presently seeking relief in the courts. This is partly due to the necessity for common carriers to have full service available even though it is not profitable to do so. If the capital structure of the reorganized Company is to be based on the earning history of the Company limited to this depression period, ignoring both the somewhat distant past, the immediate present, and the future, the result is confiscation of the interests of the preferred stockholders.

No one denies—least of all the Preferred Stockholders Committee—that the current volume of business with its

gratifying improvement in earnings is greatly helped by the existence of war and the surge of production necessitated by it. The sooner this type of prosperity is over, the better. But that the nation will immediately sink into another economic morass by no means follows. Nor does it follow that a high level of business activity may not continue for many years. There are those who believe that victory will give a new impetus to business. The great new electrical inventions that will come from new war devices, even harnessing the power of the atom; the great war-motivated strides in efficiency of production, leading to still lower costs; the increased availability of new metals such as aluminum and chemicals, natural and synthetic; strengthening of ties with our Latin-American neighbors and the Dominions of Britain now so depend upon our aid—all these may well contribute to continued business activity. Upon this must be superimposed the great vacuum of civilian demands now being created by the conversion of industry to war-time pursuits, and upon that there must be further superimposed the prolonged activity that must undoubtedly be continued long after the end of the war in order to maintain the gains and police those who need policing. This all adds up to the probability of a healthy state of business, at least for a long post-war transition period.

If there is any soundness in this analysis of the future—and it is earnestly submitted that there is—should the Preferred Stockholders be deprived entirely of the privilege of sharing in it? Today the Debtor is producing income in excess of its fixed charges. Who can possibly say that this is so temporary that the Stockholders' rights must be extinguished?

It is now proposed to outline briefly for the Court certain circumstances concerning the earning record of the Debtor which have not been fully considered by either the Court or the Commission.

**(a) The heavy maintenance program during receivership has unduly lowered the figures on earnings.**

It does not appear that any consideration has been given to the extensive maintenance program which has been conducted by the Trustees for the Debtor out of earnings since this proceeding was instituted, as a result of which the real earning capacity of the Debtor has been understated. There is testimony in the record to the effect that operations of the Debtor during the 4-year period between 1935 and 1939 have been conducted in such a manner that the interests of the junior creditors and stockholders have been unduly depreciated. (R. 1669-74.) The Preferred Stockholders Committee recognizes that the purpose of the management of the Debtor was a desire to put the road into perfect condition by the time the reorganization was completed; but in doing so, very substantial sums of money have been expended which have improved the property beyond the normal requirements of up-keep, with the result that the figures for net income are less than the actual net income would be if only maintenance required by the then volume of business was maintained. In making calculations as to the amount of income available for fixed interest based on the earning record of the Debtor during the period from 1935 to 1939, full recognition of these excessive charges must be taken into consideration in order to deal fairly with all parties—particularly the junior creditors and the stockholders. The policy has been to apply money which might otherwise be available for the payment of interest, to plant betterment. The result has been that the net income of the Debtor available for fixed charges has been reduced in such a manner as to indicate a lower earning capacity than actually exists. The policy results in the betterment of the property and plant of the Debtor and the accrual of a larger amount of interest on existing securities than would otherwise have been the case, thereby resulting

in the apparent reduction of the equity in the properties of the Debtor.

By reason of these expenditures, the plant of the Debtor has been put in such a condition that the normal future maintenance charges will be substantially reduced. The result will be that the net income of the reorganized company in the future can reasonably be expected to be greater by reason of the fact that many of the expenses which have been incurred will not be incurred in the future.

**(b) No consideration has been given to the current earning record of the Debtor.**

The Interstate Commerce Commission has determined the amount to be set up as the annual fixed charges of the reorganized capital structure of the Company, by adopting as the outside limit of such amount the annual average of two 5-year periods of very low earnings, namely, 1931 to 1935, and 1932 to 1936. The average annual earnings for the first period were $7,859,000, and for the second period, $8,042,000. Although the Commission's supplemental report was issued in June of 1940, we do not find any explanation which indicates that the Commission fully and fairly took cognizance of the remarkable increase in earnings of the Debtor after 1938. The income available for fixed charges of the Debtor as reflected in its annual report for the year ended December 31, 1939, was $9,455,449.29, an increase of over $3,350,000 over the previous year. The income available for fixed charges of the Debtor, as reflected in its annual report for the year ended December 31, 1940, was $14,866,992.92, an increase of over $5,400,000 over the year 1939. The income available for fixed charges as reflected in the annual report for the year ended December 31, 1941, was $28,939,719.27, almost double that for 1941 or an increase of gross revenue of only $25,000,000.

For the eight months ending August 31, 1942, the gross revenue was $110,426,000 as against $88,804,000 for the same period in 1941. The net income available for interest was $19,500,000 as against $17,991,000 for the same period. Considering the tremendous increase in labor costs, the showing is remarkable.

It takes little imagination to picture the railroad traffic involved in moving trainees and their equipment for our Army which is now mounting to upwards of 10,000,000 men. Favorable rail prospects ahead are: (1) excellent earnings should be maintained throughout 1943; (2) desire for greater war production indicates traffic peaks not yet seen; (3) strengthened and constantly improving financial status stemming from improved operating results; (4) probability that Congress will permit carriers to buy their own discounted obligations without tax penalty; (5) likelihood that reorganized roads will be allowed to retain the valuations for properties established prior to receivership; and (7) favorable labor cost outlook due to wage stabilizations which now appear to be assured.

To wipe out the interest of the preferred stockholders at a time such as this, with earnings such as they are and prospects as favorable as they are, is an injustice which must be avoided at all costs.

**(c) No consideration has been given to estimates of earnings from coordinations and consolidations with other roads.**

Attention is called to the fact that there is a well established policy among the railroads of the country to enter into coordinations and consolidations with competing lines for the purpose of effecting economies. This policy will undoubtedly be hastened because of the efforts of the

Office of Defense Transportation to eliminate all needless operations. So, where there are duplicating passenger station facilities, freight stations and trackage, there appears to be a definite policy on the part of alert railroad management to coordinate or abandon facilities, and, to an extent, to consolidate operations. Some of these consolidations have been under contemplation by the management of the Debtor. That these coordinations will substantially reduce operating expenses, is perfectly obvious. The effect upon net operating income is clear. So far as can be determined, the Commission has completely ignored the vast possibilities of such a program for reducing operating expenses and increasing net income. In doing so, the Commission has completely failed to be realistic about a management policy which is certain to gain increased impetus in the near future.

**(d) The Commission erred in refusing to permit studies to be made of a plan based on the consolidation of the Debtor and the Chicago and North Western Railway Company.**

The Preferred Stockholders Committee in its studies of the problems involved in the reorganization of the Debtor, reached the conclusion that there was imposed upon it an obligation to present a constructive solution to the reorganization of the Debtor. It realized that it was beyond the control of any individual group or organization to increase the volume of business of the Debtor over night or to effect the economic conditions of the Nation so that the volume of business of the Debtor might be restored to its normal level. It turned, therefore, to the advisability of developing a plan or program which would increase the earning capacity of the Debtor. Its examinations revealed that the Debtor has been extremely well managed,—particularly during the period of receivership,—so that

there was no contribution which the Preferred Stockholders Committee felt it could make in suggesting economies of operation. However, working with the Common Stockholders Committee of the Chicago & North Western Railway, the Preferred Stockholders Committee investigated, to the best of its ability, the advisability of a consolidation between the Chicago & North Western Railway Company and the Debtor.

This investigation was made on the basis of the simple and well established fact that in many respects the railroad facilities of the country have been over-developed and that the principles of an era which dictated extensive competition in transportation, are out-moded. In a rapidly growing country such as America has been for decades past, it was inevitable that much railroad mileage would be built to open up the undeveloped country. The underlying conditions which justified construction and operation of railroad trackage have radically changed, not only because of exhaustion of natural resources, but because of competition of other means of transportation and the shifting of industry from one center to another. A very substantial contraction of railroad mileage is now made inevitable by our system of good roads. The fundamental fact cannot be hidden, that particularly in the territory served by the Debtor there are more railroad facilities than are necessary. On the three main lines of the Debtor in the Middle West, namely, from Chicago to Omaha, from Chicago to the Twin Cities, and from Chicago to Green Bay, the Debtor is in direct competition with the Chicago & North Western Railway. There is also extensive competition to the first two points by several other large railroads. There are probably no two railroads in the country so ideally situated for consolidation as the Milwaukee and the North Western, and the studies which were made to justify this conclusion amply sustain it. The Interstate Commerce Commission went so

far as to permit a hearing on a motion to reopen the hearings to consider a plan of reorganization promulgated by the Preferred Stockholders Committee of the Debtor and the Common Stockholders Committee of the Chicago & North Western Railway Company. At that hearing it was indicated that the studies made to the date of the hearing showed that the savings from such consolidation would amount to at least $10,000,000 a year. Although it was not part of the efforts of the two Committees, the Reconstruction Finance Corporation had previously instituted a study of a similar nature. Every effort was made by the two Committees, before the plan was promulgated, to obtain the opinions of those qualified to pass on the propriety of such a consolidation. Although the response indicated doubt as to whether such a project would be successful, no opinion was ever expressed that the principle involved was anything other than a sound, practical and forward-looking step. The Commission itself in refusing to reopen the case did not give any reasons in opposition to the plan itself, but simply stated that the delay resulting from such an investigation would be unreasonable. That was in 1938! The Committees were amply prepared to justify the propriety of this consolidation, not only from a practical but from a legal standpoint. It is sincerely believed that there was afforded to the Commission an opportunity for a great constructive piece of work. The Committee believes that the day will come when this consolidation will be undertaken. It believes, further, that in order that they may share in the great financial benefits of such a consolidation, that the preferred stockholders should not be deprived of all of their interest in the Debtor and its properties.

## IV.

### The Effective Date of a Plan Promulgated Under Section 77 Must Be the Date of the Filing of the Petition.

The petition was filed in this case on June 29, 1935. The effective date of the plan promulgated by the Commission is January 1, 1939. The Court's attention is called to some interesting comparisons. The petition of the Chicago & Eastern Illinois was filed on April 18, 1933; the effective date of the plan was January 1, 1937.[1] The petition of the Chicago and North Western was filed on June 28, 1935; the effective date of the plan was January 1, 1939.[2] The petition of the Erie was filed on June 18, 1938; the effective date of the plan was January 1, 1940.[3] The petition of the Chicago, Rock Island & Pacific was filed June 7, 1933; the effective date of the plan was January 1, 1942.[4] There is no consistency. This lack of consistency not only causes unfairness, since among the reorganized railroads the capital structure varies with the whim of the Commission as to the date of the plan; but, what is more important, is that the arbitrary allocation of the effective date of the plan to a date far after the filing of the petition, actually deprives the debtor—and therefore the stockholders—of property without due process of law. By arbitrarily deferring the effective date of the plan, the Commission permits the accumulation of interest on the bonded indebtedness, thereby increasing the amount of the indebtedness and greatly reducing the value of the equity. Let it be said at this point, that this argument is not being advanced for the purpose of seeking to deprive the bondholders and other creditors of their right to interest on the

1. *In re Chicago and Eastern Illinois Railroad Co.* (unreported), D. C. N. D. Ill. E. D., June 16, 1939.
2. *In re Chicago and North Western Ry. Co.*, 126 F. (2d) 351.
3. *In re Erie Railroad Company*, 37 Fed. Sup. 237.
4. *In re Chicago Rock Island & Pacific Railway Co.*, 242 I. C. C. 298.

debt owned by them, but the point is strenuously urged for the purpose of insisting that the determination of the amount of debt which must be satisfied must be made as of the date of the filing of the petition. Otherwise, during the very pendency of the proceeding the rights of the stockholders are deteriorating and depreciating. We cannot find in examination of Section 77, any justification for the policy of indiscriminately determining the effective date of the plan which the Commission has adopted and the Circuit Court of Appeals, in this case, is apparently willing to confirm.

Reference is made to the language of Section 77(l):

> "(l) In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

This requires a cross-reference to Section 63 of the Bankruptcy Act (now Section 103 of the U. S. C. A. Vol. 11). This Section is as follows:

> "(a) Debts of the bankrupt may be proved and allowed against his estate which are founded upon (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition by or against him, whether then payable or not, with any interest thereon which would have been recoverable at that date or with a rebate of interest upon such as were not then payable and did not bear interest."

The rights of the secured creditor are established as of the date of the filing of the petition. Interest accrued after the filing of the petition is not considered as a part of the debt. The decisions clearly established the correctness

of this rule of bankruptcy law. In *Sexton* v. *Dreyfus*, 219 U. S. 339, the Court said:

> "For more than a century and a half the theory of the English bankruptcy system has been that everything stops at a certain date. Interest was not computed beyond the date of the commission. * * * This rule was applied to mortgages as well as to unsecured debts; * * * and notwithstanding occasional doubts it has been so applied with the prevailing assent of the English judges ever since. * * * As appears from Cooke, *sup.*, the rule was laid down not because of the words of the statute, but as a fundamental principle. We take our bankruptcy system from England, and we naturally assume that the fundamental principles upon which it was administered were adopted by us when we copied the system, somewhat as the established construction of a law goes with the words when they are copied by another state. No one doubts that interest on unsecured debts stops. See § 63(1). *Board of County Commissioners* v. *Hurley*, 169 Fed. Rep. 92, 94."

In *Board of County Commissioners* v. *Hurley*, 169 Fed. 92, 94, a helpful passage with respect to the administration of property in bankruptcy is found:

> "On that date the property of the bankrupt passes from his control to the court or its receiver, and thence to the trustee in trust for the creditors of the bankrupt in proportion to the amounts of their claims at that time. On that date there vests in each creditor as *cestui que trust* an equitable estate in such a part of the property of the bankrupt as the amount of his provable claim at that time bears to the entire amount of the provable claims against the estate. On that date the bankruptcy law deprives the creditor of all his common-law remedies to collect his debt out of the property of his debtor and to collect subsequent interest on his claim against that property, and gives him in lieu thereof this equitable estate in the property of the bankrupt. * * * Indeed the condition at the time of the filing of the petition measures the extent of the

estate and the right of all creditors of the bankrupt and all parties interested in the property throughout all the provisions of the law. * * *"

Fortunately, there exists a record of the history with respect to this particular provision of Section 77. Prior to August 27, 1935, the term "creditors" was defined in paragraph (b) of the Act as follows:

> "The term 'creditors' shall, except as otherwise specifically provided in this section, include, for all purposes of this section and of the reorganization plan, its acceptance and confirmation, all holders of claims, interests, or securities of whatever character against the debtor or its property, including claims for future rent, whether or not such claims, interest or securities would otherwise constitute provable claims under this Act."

Prior to 1935, there was no definition in the Act of "claims". By the 1935 amendments a definition of "claims" was added, which is as follows:

> "The term 'claims' includes debts, securities other than stock and option warrants to subscribe to stock, liens, or other interests of whatever character."

Public hearings were had and the Bill was revised and introduced by the Chairman of the Judiciary Committee on June 30, 1935 as H. R. 8587. The new Bill contained definitions of "securities", "stockholders", "creditors", and "claims" but the definition of "claims" was altered to read as follows:

> "The term 'claims' includes debts, whether liquidated or unliquidated, securities (other than stock and option warrants to subscribe to stock), liens, or other interests of whatever character, including interest thereon accruing after the filing of the debtor's petition."

Upon reaching the House for consideration, the Judiciary Committee introduced certain committee amendments, including the following:

> "Page 8, line 21, after the word 'character' strike out the remainder of the sentence."

This amendment was agreed to, as reflected in the Congressional Record August 15, 1935, page 13777, column 2. That portion of the definition of the term "claims" permitting the accrual of interest after the filing of the debtor's petition was eliminated. The definition of "claims" as it stands in the Act today is as follows:

> "The term 'claims' includes debts, whether liquidated or unliquidated, securities (other than stock and option warrants to subscribe to stock), liens, or other interests of whatever character."

This is an interesting recital of legislative history. In the opinion of the Preferred Stockholders Committee, there is no necessity for amplifying the argument that interest shall not be included after the date of the filing of the petition. There is nothing in the statute which requires that interest should be included during the administration of the bankrupt estate, and the legislative history indicates a contrary intent.

It follows, therefore, that the relative rights of all parties interested in the debtor's property are to be determined as of a basic date, and the new securities are to be issued as based thereon. After that basic date there is to be no further accrual of interest. The relative rights and interests of the parties are to be made definite and certain as of that date. If this conclusion is not correct, then the rights of the securityholders will shift from day to day, and, what is more important, the rights of the equityholders are dependent entirely upon the speed with which the reorganization is put into effect. If the equityholders were charged solely with this matter of acceleration of the proceeding, then there would be some justification for imposing upon them the burden of rushing the matter through; but with the system which must be followed, the unavoidable delays of hearings, reports, objections, exceptions, appeals, it is completely unsound to permit the date of the plan to be anything other than the date of the filing of the petition.

## Summary.

The Preferred Stockholders Committee respectfully requests that the decision of the Circuit Court of Appeals, in so far as it approves the elimination of the interests of the preferred stockholders, be modified. The Committee is firmly convinced that public interest dictates that the investment of the preferred stockholders of the Milwaukee Railroad should not be destroyed, in light of the facts as they exist at the present time,—that there is no sound legal ground for their destruction.

The Preferred Stockholders Committee believes that there is sufficient equity in the properties of the Debtor that there should be made to the preferred stockholders an allocation of stock in the reorganized Company. So strong is this belief, that the Preferred Stockholders Committee even hesitates to admit that the stockholders would accept less. However, the Committee recognizes that it would be a mistake to place its sights so high that in trying to get more it gets nothing. For this reason, the Court's attention is directed to sub-section (3) of section b of Section 77, which provides that

> "A plan of reorganization within the meaning of this section * * * (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance to any such creditor or stockholder of options or warrants to receive, or to subscribe for, securities of the reorganized company in such amounts and upon such terms and conditions as may be set forth in the plan * * *".

Why the Commission and the Courts have so studiously refused to recognize this provision of the statute, is difficult to ascertain. The argument has been advanced that these reorganizations should be clean-cut and that all questionable interests should be eliminated now and forever. The experience which many business men and attorneys have had with reorganizations under Section 77B should

demonstrate the unfairness of such a pessimistic view of certain industries and companies in particular and of the economic soundness of the country in general. Many of the reorganizations of industrial commercial companies have proved to be eminently satisfactory; the problems and trials of the depression period have been overcome so that real prosperity has again returned to these companies, whose future at the time of reorganization was extremely dark. With respect to the Debtor, although there is no intention to minimize the serious difficulties with which its financial structure is confronted, the fact still remains that a substantial recovery of earning power has already—even before the proceeding is terminated—been accomplished. Surely, then, the very least which the preferred stockholders have a right to expect, is that they be given a right to participate in the future of this Company, if within a reasonable period of time it can be established that the Committee's analysis of the future is soundly conceived.

The Preferred Stockholders Committee, therefore, respectfully requests that this Honorable Court modify the opinion of the Circuit Court of Appeals, by directing that all references to the lack of value of the equity be eliminated, and that the further studies to be made by the Interstate Commerce Commission shall include a careful reconsideration of the value of the equity of the preferred stockholders with a view to according these stockholders participation in any plan of reorganization as finally promulgated.

Respectfully submitted:

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